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IN THE

Supreme Court of the United States

October Term, 1981

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

Appeal from the Supreme Court of New Mexico

BRIEF OF APPELLEE

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QUESTIONS PRESENTED

1. Whether the due process clause prohibits the inclusion in apportionable business income of income earned from shares of stock and other intangibles when the income-producing intangibles were acquired and managed as integral parts of the taxpayer's regular unitary business.

2. Whether the inclusion of intangible income in apportionable business income requires alteration of New Mexico's apportionment formula, as a constitutional matter, when the amount apportioned to New Mexico by the unchanged formula is reasonably related to the taxpayer's activities in the state.

3. Whether New Mexico may define a taxpayer's business income by reference to its federal taxable income, without adjustment, when the federal amount includes section 78 dividends.

4. Whether the foreign commerce clause bars a state from including in the apportionable business income of a domestic taxpayer its dividend income earned from its investments in stock of a foreign corporation.

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BRIEF OF APPELLEE

STATEMENT OF THE CASE

The taxpayer in this case is F. W. Woolworth, a New York corporation. It operates a single, integrated business in the United States, Puerto Rico and the Virgin Islands. (J.A. 10a)

Woolworth's activities in New Mexico are substantial. During 1976, Woolworth had $8.8 million[1] of tangible assets located in New Mexico, had a payroll of almost $2 million, and made sales of more than $13 million within the state. (J.A. 57a) Yet Woolworth contends that formulary attribution of $401,000 of income to New Mexico in fiscal 1977, and the resulting New

[1] These numbers are rounded for convenience. Precise amounts appear on Woolworth's corporate income tax return in the Joint Appendix, at 55a and 57a.

Mexico tax liability of $20,000, violates the due process and commerce clauses of the United States Constitution. Implicit in its argument is the conclusion that the Constitution allows New Mexico only $4,358 return for the opportunity New Mexico provided Woolworth to obtain $13 million in gross receipts here.

The constitutional controversy arises from the requirements of New Mexico's tax statute.[2] Despite this Court's holding in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), that dividend income received from foreign subsidiaries may be included in apportionable income, Woolworth argues that the Constitution prohibits inclusion of dividend income and foreign exchange gain in a taxpayer's apportionable business income. Additionally, Woolworth objects to New Mexico's reliance on federal taxable income as the base for the state's income tax, insofar as that method results in the inclusion of section 78 dividends (gross-up) as apportionable business income.

Under the New Mexico statute,[3] a multistate taxpayer such as Woolworth has two choices: it may determine its New Mexico taxable income by separately accounting for its New Mexico activities; or it may elect to determine the amount of its total business income attributable to New Mexico by allocating and

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[2] New Mexico's income tax statute was changed substantially by the 1981 Legislature. Those changes essentially divided the Income Tax Act into a personal and a corporate statute, and made other, substantive changes. However, none of the substantive changes affects the substance of the statutory sections discussed in this brief. For purposes of this brief, statutory cites are to the pre-1981 New Mexico Income Tax Act, unless indicated otherwise. The New Mexico statutes applicable to this case are set out in the appendix.

[3] New Mexico has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), with few modifications. It has also joined in the Multistate Tax Compact, §§7-5-1 through 7-5-7 NMSA 1978.

apportioning its total business[4] income under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). Woolworth chose to report to New Mexico under UDITPA. Under UDITPA, business income is:

> income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations;

Section 7-4-2(A) NMSA 1978.

UDITPA apportions income in accordance with unitary business principles. A finding that income is business income under UDITPA, is equivalent to a finding that such income is unitary business income. *See Tipperary Corp. v. New Mexico Bureau of Revenue,* 93 N.M. 22, 595 P.2d 1212, (Ct.App. 1979), *cert. denied,* 92 N.M. 675, 593 P.2d 1078 (1979).

A taxpayer's business income is normally[5] the same amount as its federal taxable income, unless the taxpayer shows that some portion of its total income is attributable to nonbusiness activities. Nonbusiness income is allocable in accordance with

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[4] If the taxpayer reporting to New Mexico is part of a multicorporate unitary business, as Caterpillar Tractor Co. was shown to be in *Chicago Bridge and Iron Co. v. Caterpillar Tractor Co., prob. juris. noted,* __U.S.__, No. 81-349, New Mexico law allows a combined report of all the corporations included in the unitary business. In a combined report, the income of all the included corporations is combined (excluding income from intercorporate transactions) to indicate the business income of the combined group, and the total income is apportioned by reference to the property payroll and sales of all the corporations whose income is included in business income. (R. 49; N.M. Income Tax Regulation 18(b)(2), at R. 130 on back)

[5] Excluded by statute from federal taxable income are certain amounts taxed under the Banking and Financial Corporations Tax Act, and amounts a state is prohibited from taxing by law or constitution. Section 7-2-2(S) and (T) NMSA 1978. (J.S.A. 45a)

UDITPA rules. Sections 7-4-5 through 7-4-9 NMSA 1978. (Appendix A, p. 3a-4a)

On its federal return, Woolworth reported total income for its fiscal year ending January 31, 1977, as $997 million. After deductions, Woolworth's federal taxable income totaled $87 million. In its New Mexico return, Woolworth subtracted $69 million from this taxable income amount as "nonbusiness income." This nonbusiness income consisted of $65.4 million of dividend income,[6] $2.4 million of interest income and $1.6 million of income from an investment it calls a foreign exchange hedging transaction. (J.A. 57a) Woolworth reported no expenses related to any of these items of income.[7] By virtue of this subtraction of alleged nonbusiness income, Woolworth calculated its total apportionable business income to be $18.3 million. Application of the apportionment formula to this amount resulted in apportionment of only $84,000 of income to New Mexico. The tax Woolworth paid on this amount was $4,358.[8]

Upon audit, the New Mexico Taxation and Revenue Department (hereinafter, New Mexico) determined that Woolworth erroneously classified the $69.3 million as nonbusiness income, and New Mexico restored that amount to the business income total.

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[6] Included in the $65.4 million of dividend income was $25.5 million of gross-up. Gross-up is part of the federal formula allowing a taxpayer to claim a credit for taxes paid by a subsidiary corporation if it increased its gross income by the amount deemed to have been paid. *See* discussion, *infra*, p. 35.

[7] Since the UDITPA allocation and apportionment provisions apply to "net" income, the expenses connected with an item of nonbusiness income must be considered as nonbusiness expenses, and allocated in accordance with the income to which it is related.

[8] Section 7-2-8 NMSA 1978 provided a corporate tax rate of five percent. This amount has since been changed to a sliding scale ranging from four to six percent, depending upon the amount of New Mexico income. Section 7-2A-5 NMSA 1978 (1981 Repl. Pamph.).

New Mexico then added into "sales everywhere"[9] the amount Woolworth received as dividends, interest and foreign exchange gain, which addition resulted in an adjusted apportionment formula and a reduction in the percentage of Woolworth's total sales attributable to New Mexico.[10] (J.A. 69a) The use of the numbers calculated by the taxpayer as the property percentage and the payroll percentage, and the reduced sales percentage calculated by New Mexico resulted in a smaller and more realistic representation of the proportion of the total business income of the taxpayer attributable to New Mexico. New Mexico applied the resulting percentage, .458335 percent – less than one-half a percent – to the amount concluded to be the taxpayer's business income, and determined that Woolworth had underpaid New Mexico by $15,845 plus interest. (J.A. 67a-68a) The taxpayer's protest[11] to the ensuing assessment brought the case to hearing before a Taxation and Revenue Department hearing examiner.

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[9] "Sales" means "gross receipts," §7-4-2(E) NMSA 1978.

[10] *Woolworth's original formula:*

$13,253,425 N.M. sales / 2,507,990,364 sales everywhere = .528448% sales in N.M.

$ 1,996,950 N.M. payroll / 482,517,853 payroll everywhere = .413860% payroll in N.M.

$ 8,750,664 N.M. property / 1,958,028,204 property everywhere = .446912% property in N.M.

$$\frac{.528448\%\ (\text{sales}) + .413860\%\ (\text{payroll}) + .446912\%\ (\text{property})}{3} = .463073\%$$ of Woolworth's business activities taking place in N.M.

New Mexico's changes to the formula:

$13,253,425 N.M. sales / 2,577,319,999 sales everywhere = .514233% sales in N.M.

$$\frac{.514233\%\ (\text{new sales}) + .413860\%\ (\text{same payroll}) + .446912\%\ (\text{same property})}{3} = .458335\%$$ of Woolworth's business activities taking place in N.M. (reduced from .463073% submitted by Woolworth).

[11] J.A. 67a.

The evidence in this case establishes that Woolworth's entire income is business income of its unitary business. Woolworth has consistently maintained that its domestic[12] operations constitute a unitary enterprise. (R. 149) Some of Woolworth's unitary income arises from its activities operating retail stores, which use the names Woolworth and Woolco. (J.A. 10a) However, the taxpayer's retail activities are by no means the only source of income admitted to be business income. Woolworth derives business income from interest on loans made by it as "part of the regular trade of [*sic*] business of Woolworth." (J.A. 9a) Specifically, in this case, interest was paid to Woolworth by its Canadian subsidiary (R. 141) which also paid some of the dividend income that Woolworth argues is *not* business income. Woolworth also admits that "in the regular course of its business" it routinely invests in commercial paper and treasury notes. (J.A. 27a) Thus, neither the nature of the dividend income, as income from intangibles, nor the fact that it is paid by Woolworth's foreign subsidiaries, distinguishes it from Woolworth's other conceded business income.

Moreover, the evidence shows that Woolworth's regular trade or business activities include extensive management of the intangible property from which the dividends in this case are derived. The taxpayer owns a majority interest, either directly or through subsidiaries, in at least 32 subsidiary corporations (R. 140, Appendix B, p. 10a). Many of these are corporations operating under the Woolworth name all over the world.[13] Of these Woolworth corporations, the English, German, Canadian and Mexican operations paid dividends to their parent in 1976.

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[12] "Domestic" is used here to indicate Woolworth's operation in the United States, Puerto Rico and the Virgin Islands.

[13] The exhibit submitted by the taxpayer showing its corporate structure indicates Woolworth corporations operating in Canada, Germany, England, Austria, Jamaica, Trinidad, Barbados, Spain, Southern Rhodesia and Mexico. (Appendix B, p. 10a)

F. W. Woolworth Co., Ltd., is an English corporation, 52.7 percent of which is owned by taxpayer. F. W. Woolworth, Gmbh, the German subsidiary, F. W. Woolworth, Ltd., the Canadian subsidiary, and F. W. Woolworth, S.A. de C.V. Mexico are wholly owned subsidiaries of the taxpayer. (J.S.A. 33a) These foreign subsidiaries conduct the same type of retail operations as does the taxpayer, under the Woolworth name. (J.A. 21a-22a) The taxpayer's overall financing and planning include and are integrated with that of its foreign subsidiaries and affiliates. (J.A. 27a-28a)

Management autonomy has been granted to each subsidiary in accordance with development of its abilities to act independently of the taxpayer. (J.A. 26a, 29a) The New York parent, in recognition that the success of a marketing operation such as a Woolworth store depends upon its ability to determine and cater to the needs of the people comprising the market, has developed a uniform "merchandising concept" applicable to all of its subsidiaries: goods sold in local stores should be obtained locally, if possible (J.A. 25a), and responsibility should be delegated to a subsidiary commensurate with its ability to operate effectively and profitably. (J.A. 30a)

Despite this management policy, the record reflects that the parent has ultimate control of and constant involvement in the operation of those subsidiaries. Considerable communication between the parent and subsidiaries is evident from the presence of a teletype system and travel of executive personnel of both the foreign subsidiaries and the domestic parent. (J.A. 34a) At top management levels, the taxpayer and its subsidiaries have regular informational exchange, especially with regard to major decisions. (J.A. 35a-36a, 37a) Any sizeable borrowing by a subsidiary requires the approval of the taxpayer. (J.A. 28a) In summary, Woolworth generally oversees the operation of its foreign subsidiaries. (J.A. 49a) These facts, combined with the inclusion of the Canadian, Mexican and German corporations in the taxpayer's consolidated financial statements (J.A. 48a),

indicate that investors are attracted to Woolworth by the impression that Woolworth is a worldwide merchandising operation, and therefore less vulnerable to vacillating regional financial slumps and special local problems. Thus, the business benefit to the taxpayer of its stock ownership is not only the money it receives as dividends, but also the value to Woolworth of the public knowledge that Woolworth is an international retail merchandising operation.

Woolworth's concentration of its sizeable investments is further indication of their business purpose. For example, the relatively small ($64,000) initial investment in its English subsidiary was increased by reinvesting declared dividends into the growing subsidiary, so that now the book value of that investment is approximately $30 million. (J.A. 16a-17a) Investment in the other corporations has increased similarly. (J.A. 18a, 28a, 29a, 31a) Occasional parental loans also aided in the growth of these corporations. (J.A. 28a) These investments required initial management involvement by the parent, which has reduced as those subsidiaries matured and became capable of handling their own affairs. (J.A. 26a) Woolworth's motivation for incurring the risks of financing the establishment of new businesses, rather than choosing a conservative investment, is to obtain profits from the "know-how" acquired in its established merchandising business. The singular fact that many of the management functions have been delegated to subsidiaries does not eliminate the unitary business nature of this series of expansion investments.

In communicating with and overseeing its subsidiaries, the taxpayer incurs significant business expense. For example, the taxpayer maintains a vice-president to act as liaison with the smaller foreign subsidiaries, (J.A. 50a) including the Mexican subsidiary which paid some of the dividends at issue here. Yet Woolworth does not allocate that vice-president's salary, incidental expenses and the cost of his staff as nonbusiness expenses incurred in producing its claimed nonbusiness income. There-

fore, Woolworth is in the untenable position of arguing that its dividend income is nonbusiness income, while at the same time benefitting from its treatment as ordinary business expenses the costs of production of that income. Woolworth's New Mexico tax return also fails to reflect as allocable nonbusiness expenses other expenses related to the production of the income at issue. Unaccounted for are: travel expenses related to attending meetings of the foreign boards (J.A. 16a, 23a, 29a, 39a), the expense of maintaining a teletype system for communicating with foreign subsidiaries (J.A. 34a), the expense of including the Mexican subsidiary in Woolworth's pension plan (J.A. 51a), and the salary and overhead expense related to a foreign exchange hedging investment.[14] (J.A. 53a) Under New Mexico law, a taxpayer is required to allocate and apportion its expenses in the same manner as it does the income to which those expenses relate. Woolworth's failure to reflect these expenses in its allocation (J.A. 57a) underscores the inconsistency between its characterization of its unitary business to this Court and the reality of its day-do-day business conduct.

At the hearing, and in the appellate courts, Woolworth argued that its dividend and foreign exchange income, as nonbusiness income, was allocable to Woolworth's state of commercial domicile, New York. (R. 146) Its present contention that no state has jurisdiction to tax its dividend income and foreign exchange gain is in direct conflict with its prior concession. No New Mexico tribunal was offered the opportunity to consider the implications of Woolworth's present commerce clause argument.

The hearing examiner upheld inclusion in apportionable income of the challenged amounts and found no evidence requiring modification of the formula. This opinion was reversed by the New Mexico Court of Appeals on statutory grounds.

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[14] *See* discussion of the foreign exchange gain, *infra*, at p. 33.

The New Mexico Supreme Court, by writ of certiorari, reversed the Court of Appeals and reinstated the opinion of the hearing examiner, finding that inclusion of the contested amounts was statutorily required, and violated neither the due process nor the commerce clauses of the United States Constitution. The Court found "nothing arbitrary or unreasonable about the Department's conclusion that dividend income is apportionable without modification of the formula" beyond the sales factor modification discussed above, and agreed with the hearing examiner that Woolworth had failed in its burden of showing "clear and cogent evidence" of taxation of extraterritorial values or any "evidence upon which further adjustments could be predicated under the relief provisions of UDITPA." (J.S.A. 21a)

SUMMARY OF ARGUMENT

1. The Due Process Clause, and Apportionment of Dividends and Other Intangible Income.

The general principle applicable to this case is that if a business is unitary, and part of it operates within the taxing state, the state may determine the portion of that business's income attributable to the state by application of a formula which reflects the taxpayer's activities within the state compared to its activities everywhere. Such a method is presumed constitutionally valid.

Woolworth fits the description to which the general rule applies. Woolworth operates a unitary business nationwide, which taxpayer admits includes merchandising, intangible investment and lending money to subsidiary corporations. Woolworth contends that its dividend income is different from its other income. This Court in *Mobil* firmly rejected the notion that dividend income received from a business's foreign subsidiary corporations is distinguishable from other business income of a unitary business. The evidence before the Court and the

applicable law clearly indicate that the challenged income is apportionable business income of Woolworth's unitary domestic business.

Only two factual situations require a constitutional exception to the general rule permitting full formulary apportionment: income derived from a business discrete from and unrelated to the taxpayer's business conducted in the taxing state must be excluded from apportionable income; and income attributed to a state through the apportionment formula must not be out of all proportion to values connected with the taxing state. The taxpayer fits within neither exception.

New Mexico has not taxed the income of Woolworth's foreign subsidiaries, and therefore it does not matter whether those foreign subsidiaries conduct a business discrete from Woolworth's business. Woolworth argues that dividends received from its foreign subsidiaries meet the discrete business exception, on the theory that *Mobil* precludes a state from treating such dividend income as apportionable business income unless the corporations paying the dividends constitute an integral part of the unitary business of the taxpayer. The substance of Woolworth's contention is that dividend income may be taxed by a state only if that state has jurisdiction to tax the payor of the dividends. The case law, however, is clear that dividend income is distinct from the income of the underlying corporation, and may be separately taxed. Intangible assets themselves give rise to income, which is taxable by reference to the activities of the recipient. There is no logical reason for treating this income differently from any other income of the unitary business.

The foreign exchange gain is analogous to any other income Woolworth receives from investing in intangibles. Woolworth's activities in earning the foreign exchange gain are closely analogous to its commercial paper investments, which it concedes produce business income. The record reveals no facts justifying a due process exclusion of this income from apportionable business income.

Nor has Woolworth established that it fits within the second exception to the general rule: that formulary apportionment of Woolworth's income results in taxation out of all proportion to its activities and values in New Mexico. No evidence was introduced to show overreaching by New Mexico, and it is difficult to conceive what evidence might show a tax of $20,000 to be excessive in light of Woolworth's enormous holdings of tangible property in New Mexico, its large New Mexico payroll, and the $13 million in gross receipts Woolworth earned in New Mexico during the relevant tax period.

Despite this Court's steadfast requirement that a taxpayer must produce clear and cogent evidence to overcome the presumption of validity of formulary apportionment, Woolworth seeks a finding of *per se* invalidity because of the large percentage of its income attributable to dividends. The taxpayer's argument depends upon its assumption that inclusion of dividends in apportionable income is equivalent to inclusion of the profits of the payor corporations. New Mexico has not taxed the income of the foreign corporations, but only that of the domestic Woolworth corporation. Therefore, no violation of the due process clause has occurred, and accordingly no adjustment to the apportionment formula is required.

2. The Due Process Clause and Section 78 Dividends.

Woolworth maintains that New Mexico is constitutionally required to grant it a deduction from taxable income for the amount it included in its federal taxable income under section 78 of the Internal Revenue Code (gross-up). New Mexico defines taxable income by reference to federal taxable income. In the case of a multistate taxpayer, the amount it reports as federal taxable income and the amount it must report as apportionable business income are the same unless the taxpayer shows part of the income to be nonbusiness income. New Mexico included this amount in Woolworth's taxable income because Woolworth

included it in Woolworth's federal taxable income. This same reliance on federal taxable income is evident in the taxation statutes of many states.

Section 78 of the Internal Revenue Code requires a domestic corporation which elects to take a credit pursuant to section 902 of the Code for taxes paid by its foreign subsidiary to recognize increased dividend income. The amount which the taxpayer must recognize is treated as income for purposes of other sections of the Code. The legislative history of section 78 indicates that Congress intended to require the recognition of additional income by domestic corporations claiming this foreign tax credit.

Woolworth's only argument in support of its contention that the inclusion of section 78 dividend income violates the due process clause is that "gross-up" is not income within the meaning of the sixteenth amendment. The states, of course, are not governed by the sixteenth amendment but by the due process clause. The taxpayer has not met its burden under the due process clause of showing that the tax imposed by New Mexico is out of all proportion to values connected with the taxing state.

3. The Foreign Commerce Clause

Woolworth's foreign commerce clause argument is premised entirely on *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), a case which differs so radically from the facts at hand that, as this Court held in *Mobil,* any reliance on it is "forced."

Woolworth has nonetheless attempted to revive the *Japan Line* argument and to avoid the *Mobil* precedent by changing one fact. Throughout the course of this litigation, Woolworth has consistently conceded that its dividend income and foreign exchange gain were allocable to New York, its state of commercial domicile. After *Mobil* so conclusively disposed of any

foreign commerce clause argument in the instance where the taxpayer concedes that *some* state has a right to tax income, Woolworth changed its position. Woolworth now maintains that the dividends it received from foreign corporations are not taxable by any state. However, retraction of this concession is insufficient to distinguish Woolworth's commerce clause argument from Mobil's. Like Mobil's, Woolworth's income from its intangible investments is subject to tax by at least one state because the income is earned by activities in the United States. Accordingly, Woolworth cannot avoid the holding in *Mobil.*

Japan Line addressed the taxation of foreign commerce, which the taxpayer here admits is only involved if New Mexico's tax reaches income generated from activities abroad. Since New Mexico's tax is properly apportioned to reflect only activities within New Mexico, the foreign commerce clause is not relevant. Finally, Congress has not prohibited the states from taxation of an apportioned share of a United States domiciled corporation's dividends from foreign commerce; in fact congressional policy permits taxation of the foreign source dividends.

ARGUMENT

I. NEW MEXICO'S INCLUSION OF DIVIDENDS AND FOREIGN EXCHANGE GAIN IN APPORTIONABLE INCOME COMPLIES WITH THE DUE PROCESS RESTRICTIONS ON STATE TAXING POWERS.

Woolworth challenges the power of New Mexico to include income in the form of dividends from foreign subsidiaries in apportionable income. This Court, in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425 (1980), has

already held that the inclusion of dividend income received from foreign subsidiaries in the apportionable business income of a domestic taxpayer conducting part of its unitary business in the taxing state does not violate due process. The question addressed by the Court in *Mobil* was "whether there is something about the character of income earned from investments in affiliates and subsidiaries operating abroad that precludes, as a constitutional matter, state taxation of that income by the apportionment method." 445 U.S. at 435. The Court found no special characteristics prohibiting states from including dividends from foreign subsidiaries in the apportionable tax base.

New Mexico contends that Woolworth's dividend income is properly apportionable because it is part of the business income derived from the operation of Woolworth's domestic unitary business, and therefore meets the due process standards for apportionability. No further adjustments to the apportionment formula are necessary, because Woolworth has not shown that application of New Mexico's apportionment formula to Woolworth's unitary business income results in attribution of income to New Mexico out of proportion to Woolworth's New Mexico activities and properties.

A. The Dividends Received by Woolworth from Its Foreign Subsidiaries Are Income Received by Woolworth in the Conduct of the Ordinary Business Affairs of Its Unitary Business.

The parties have no disagreement as to the boundaries of Woolworth's unitary business. Both the taxpayer and New Mexico describe Woolworth as operating a unitary business in the fifty states, Puerto Rico and the Virgin Islands. The controversy here is limited to the question of whether the substantial income received by this taxpayer as dividends from its

foreign subsidiaries is part of the taxpayer's unitary business income[15] and therefore apportionable.

The New Mexico Supreme Court found that the dividend income from Woolworth's stock investments was business income.[16] This finding is supported by the facts in the record:[17]

- The taxpayer has a substantial number of investments in subsidiaries conducting Woolworth merchandising operations very similar to its own. The existence of Woolworth stores worldwide is an obvious business benefit to Woolworth and indicates that investment in these subsidiaries was motivated by business considerations. The taxpayer's management is actively involved in overseeing the activities of those subsidiaries, insofar as important decisions are concerned.[18]

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[15] A finding that income of a multistate business is "business" income under UDITPA is equivalent to a finding that it is income to a unitary business and therefore apportionable according to the unitary business principles, discussed *infra*, at p. 20 *et seq. See Tipperary Corp. v. New Mexico Bureau of Revenue*, 93 N.M. 22, 595 P.2d 1212 (Ct.App. 1979), *cert. denied* 92 N.M. 675, 593 P.2d 1078 (1979); *Albany Int'l Corp. v. Halperin*, 388 A.2d 902 (Me. 1978); *Montgomery Ward & Co. v. Commissioner of Taxation*, 276 Minn. 479, 151 N.W.2d 294 (1967); *Qualls v. Montgomery Ward & Co.*, 266 Ark. 207, 585 S.W.2d 18 (1979).

[16] "The income arose from activities of Woolworth in the regular course of its business. The income was acquired and managed as an integral part of its regular business operations. §7-4-2(A). The purpose for acquiring and holding the stock is related to its business operations N.M. Ind. [*sic*] Tax Regulation 17(a). The three-prong *Tipperary* test of Judge Wood is fully met by the evidence in favor of apportionability." (J.S.A. 14a)

[17] The facts described below are discussed in greater detail in the Statement of the Case, *supra*, pp. 1-10, wherein citations to the record are provided.

[18] *See Xerox Corp. v. Comptroller of Treasury*, 290 Md. 126, 428 A.2d 1208 (1981).

- The taxpayer issues a consolidated financial statement in its Annual Report including three of the four subsidiaries in question here, thereby utilizing these assets to help insure available capital from potential Woolworth shareholders.[19]

- The taxpayer commingles the income received as dividends from these investments in its general treasury; no evidence in the record contradicts the reasonable conclusion that the dividends are used by the corporation to pay its general business expenses.[20]

- The taxpayer incurs substantial expense in communicating with and overseeing its foreign investments, and has not shown that it treats these expenses as nonbusiness expenses.[21]

- The corporate management of Woolworth participates in managing the foreign subsidiaries, at the board of directors level, and chooses the individuals who actually manage the subsidiaries.

- The taxpayer concedes that part of the ordinary business operations of the taxpayer include investing in intangibles such as commercial paper and treasury notes, and that making loans is also a part of its regular trade or business activities.

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[19] *See W. R. Grace & Co. v. Commissioner of Revenue*, 378 Mass. 577, 393 N.E.2d 330 (1979).

[20] Commingling income from a particular activity with general business income is some indication that the taxpayer considers all the income to be business income, especially when expenses related to the item of activity are deducted as business expenses, for federal income tax reporting purposes. *See Corning Glass Works v. Department of Revenue*, 616 S.W.2d 789 (Ky. Ct. App. 1981); *Qualls v. Montgomery Ward & Co.*, 266 Ark. 207, 585 S.W.2d 18 (1979).

[21] Under UDITPA, a taxpayer allocating nonbusiness income must accordingly allocate any corresponding nonbusiness expenses. New Mexico Income Tax Regulation 17c. (R.130)

Absence of evidence in the record indicating that the income was earned in a separate business is also significant.[22]

It is not a new or unusual concept to view investments as an integral part of a taxpayer's business:

> Nor can it be justly said that investments have no real relation to the business transacted by a corporation. The possession of large assets is a business advantage of great value; it may give credit which will result in more economical business methods; it may give a standing which shall facilitate purchases; it may enable the corporation to enlarge the field of its activities and in many ways give it business standing and prestige.

Flint v. Stone Tracy Co., 220 U.S. 107, 166 (1911).

Woolworth unrealistically maintains that its business consists solely of its merchandising activities. The record reflects several Woolworth activities producing income in 1976: operating its domestic retail stores; owning and actively overseeing the substantial stock investments producing the dividend income in dispute; speculating on the foreign exchange; lending money; investing in commercial paper. Several of these activities produce income from intangibles. The record contains no factual basis for distinguishing taxpayer's dividend income from its stock investments from its other income from intangibles, and Woolworth cites no authority for such a distinction.

At the evidentiary hearing, Woolworth made no attempt to show that its investment activities were not part of its business, but concentrated its efforts on showing that Woolworth was not functionally integrated with its foreign subsidiaries, a showing New Mexico contends is irrelevant to the question of whether Woolworth's intangible investments are part of its unitary

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[22] Since it is a taxpayer's burden to show that some of its activities are part of a discrete business enterprise or done for a nonbusiness purpose, *Mobil*, 445 U.S. at 439, the absence of evidence in the record allows us to assume the necessary unity.

business. *See In Re Goodyear Tire & Rubber Co.*, 133 Vt. 132, 335 A.2d 310, 311-312 (1975).

Developing jurisprudence in the recent state court opinions on the question of investment income apportionability is consistent in allowing full apportionability of income from intangibles, if the intangible investments are part of a taxpayer's business, without regard to whether the business underlying the intangible investments is actually unitary with the investor. *See W. R. Grace & Co. v. Commissioner of Revenue*, 378 Mass. 577, 393 N.E.2d 330 (1979) (focusing on the purpose of taxpayer's investment in a beer brewing company to find the stock part of taxpayer's chemical business); *Qualls v. Montgomery Ward & Co.*, 266 Ark. 207, 585 S.W.2d 18 (1979) (finding loans to subsidiaries to be an integral part of a taxpayer's merchandising business); *Xerox Corp. v. Comptroller of Treasury*, 290 Md. 126, 428 A.2d 1208 (1981) (finding royalty and interest income to be unitary business income without regard to relationship with payor). *Accord, Montana Department of Revenue v. American Smelting & Refining Co.*, 173 Mont. 316, 567 P.2d 901 (1977), *appeal dismissed*, 434 U.S. 1042 (1978) (income from intangible investments, including stock, are part of the unitary business, without regard to whether the payor is part of the recipient's unitary business).[23]

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[23] Other cases including intangible income as apportionable unitary business income, without regard to the unity of the payor's activities with the recipient: *American Smelting & Ref. Co. v. Idaho State Tax Comm'n*, 99 Idaho 924, 592 P.2d 39 (1979), *vacated*, 445 U.S. 939 (1980), *reinstated*, 102 Idaho 38, 624 P.2d 946 (1981); *Albany Int'l Corp. v. Halperin*, 388 A.2d 902 (Me. 1978); *Montgomery Ward & Co. v. Commissioner of Taxation*, 276 Minn. 479, 151 N.W.2d 294 (1967); *Great Lakes Pipe Line Co. v. Commissioner of Taxation*, 272 Minn. 403, 138 N.W.2d 612 (1965), *appeal dismissed*, 384 U.S. 718 (1966); *Champion Int'l Corp. v. Bureau of Revenue*, 88 N.M. 411, 540 P.2d 1300 (Ct.App. 1975); *Sperry & Hutchinson Co. v. Department of Revenue*, 270 Or. 329, 527 P.2d 729 (1974); *In re Goodyear Tire & Rubber Co.*, 133 Vt. 132, 335 A.2d 310 (1975);

(Cont. p. 20)

B. Due Process Is Not Violated by the Inclusion of Dividends in Woolworth's Apportionable Business Income.

The growing presence of multistate and multinational businesses doing business in the individual states has caused special challenges to each of those states in devising equitable and practical methods of taxing, so as to obtain from these enterprises a return reasonably related to "opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940). The task of the state government is particularly difficult, given the increasing complexity in business relationships and the diversity of interrelated business enterprise conducted.[24] Recognizing the needs of the states, this Court has been reluctant to interfere with state methods of taxation, unless it is proven by clear and convincing evidence that the state's taxing scheme violates the "extremely limited restrictions that the Constitution places upon the states." *Id.* at 445. *See Bass, Ratcliff & Gretton, Ltd., v. State Tax Commission*, 266 U.S. 271 (1924); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

There are two "extremely limited restrictions" imposed by the due process clause. First, there must be some minimal connection between the activities of the interstate business and the taxing state. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267

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23 (Cont. from p. 19)
F. W. Woolworth Co. v. Commissioner of Taxes, 130 Vt. 544, 298 A.2d 839 (1972); *Gulf Oil Corp. v. Morrison*, 120 Vt. 324, 141 A.2d 671 (1958); *Corning Glass Works v. Department of Revenue*, 616 S.W.2d 789 (Ky. Ct.App. 1981).

24 *See* Corrigan, Schoettle & Dexter, *The Search for Equity and Accountability in State and Local Taxation of Multistate-Multinational Corporations*, 12 URB. LAW. 553 (1980); Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401 (1976).

(1978); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980). The minimal connection necessary is satisfied if the business being taxed carries on its business within the state. *Wisconsin v. J.C. Penney*. If the business being taxed is a unitary one, with operations both within and without the state, nexus is supplied by the presence of part of the unitary business within the state. *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980). The second due process requirement is that "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing state.' " *Moorman Mfg. Co. v. Bair*, 437 U.S. at 273, quoting *Norfolk & Western R. Co. v. State Tax Commission*, 390 U.S. 317, 325 (1968). This second requirement is discussed *infra* at p. 25.

Because the taxpayer is a unitary business and conducts part of its business in New Mexico, it cannot avoid the imposition of New Mexico's tax, unless it can show that part of the income included in the apportionment formula is earned by the taxpayer in a business discrete from and unrelated to the business conducted in the taxing state. *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. at 224. In the context of this case, to meet the burden[25] of showing income from a discrete business, Woolworth would have had to show that the dividend income it wished to allocate arose from a business separate from the unitary merchandising business operating in the taxing state.[26]

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[25] The burden of showing that income is derived from a discrete business enterprise not connected with the taxing state is on the taxpayer. *Exxon Corp. v. Department of Revenue*, 447 U.S. at 224.

[26] Woolworth's concession that a securities dealer's dividend and interest income may be apportionable business income cannot be reconciled with its contention that due process requires functional integration of a foreign corporation and its domestic shareholder as a condition precedent to the apportionability of income. *See Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980); *Johns-Manville Products Corp. v. Commissioner of Revenue*, 115 N.H. 428, 343 A.2d 221 (1975), *appeal dismissed*, 423 U.S. 1069 (1976).

Woolworth attempts to do this by arguing that the dividends are attributable to the separate businesses of its foreign subsidiaries, relying on *Mobil* for the proposition that dividends may not be included in apportionable net income of the recipient unless the subsidiary or affiliated corporation in which the stock is held is a functionally integrated part of the unitary business being conducted partially within the taxing state. (Brief of Appellant at 14)[27]

The taxpayer's reading of the Court's holding in *Mobil* is incorrect. As the Court stated, the issue in *Mobil* was whether, where most[28] of the dividend paying corporations were in fact engaging in business activities forming part of Mobil's unitary petroleum enterprise, dividends received by the parent were includable in apportionable business income. *Mobil,* 445 U.S. at 439. The Court expressly refused to decide whether such dividends would be includable, if the business of the payor had "nothing to do with the activities of the recipient." *Mobil,* 445

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[27] The taxpayer also relies heavily on the case of *Square D Co. v. Kentucky Board of Tax Appeals,* 415 S.W.2d 594 (Ky. 1967), as support for its theory that dividends may not be part of business income unless the payor and the payee are unitary. *Square D* has no remaining vitality in light of *Corning Glass Works v. Department of Revenue,* 616 S.W.2d 789 (Ky. Ct.App. 1981), wherein the court found income from capital gains, interest and royalties to be part of the regular business income of the taxpayer, and therefore apportionable in compliance with due process, and refused to follow its prior holding in *Square D,* distinguishing that case on the ground that the statute construed in *Square D* had been amended, and ignoring the constitutional analysis in *Square D.* 616 S.W.2d at 794. Thus, *Square D* may no longer be relied upon in support of Woolworth's constitutional arguments.

[28] Another indication that the Court in *Mobil* did not intend to limit dividend apportionability to situations where a dividend payor is functionally integrated with its owner is the fact that it found apportionable the dividends paid to Mobil by ARAMCO, of which Mobil owned only 10 percent of the capital stock. *Mobil,* 445 U.S. at 430 n.5. This limitation on ownership would seem to preclude a finding of unity.

U.S. at 442. Moreover, the Court made no mention of the case where the taxpayer's investment in the dividend paying corporations contributes to and enhances the value of the taxpayer's business, but such corporations are not a unitary part of the taxpayer's business. Since neither of these two factual situations was before the Court, it cannot be said that *Mobil* determined the constitutionality of including dividends in apportionable business income in those situations.

The Court in *Mobil* expressly cited and reaffirmed prior case law on the subject of state taxation of a unitary business, and addressed the question of whether there is something about the nature of dividend income that distinguishes it from other business income. *Mobil*, 445 U.S. at 440. The Court answered that question in the negative. It certainly required no deviation from precedent to find, where the taxpayer had actually invested its money to acquire ownership in companies which directly assisted Mobil in completion of the goals of its business, that the income from its investments was part of its unitary business.

The extension of *Mobil* that Woolworth advocates would require the Court to overrule precedents of long standing which have neither been eroded nor even questioned by this Court up until now. This taxpayer urges the Court to hold that stock dividends received by a domestic corporation from a foreign corporation may not be included in apportionable business income unless the payor is unitary with the payee. A necessary corrollary to such a holding would be that the dividend income is attributable to activities of the payor, rather than to investment activity of the recipient. The Court has recognized that "the property of the shareholders in their respective shares is distinct from the corporate property, franchises and capital stock, and may be separately taxed." *Hawley v. Malden*, 232 U.S. 1, 9 (1914). "When we are dealing with the intangible interests of the shareholder . . . the jurisdiction to tax it is not dependent upon the location of the lands and chattels of the corporation." *Hawley v. Malden*, 232 U.S. at 11. Again, in

Klein v. Board of Tax Supervisors, 282 U.S. 19 (1930), this Court, speaking through Mr. Justice Holmes, based its decision affirming the power of the state to tax holders of stock upon the difference between ownership of stock in a corporation and ownership of the corporation itself. "There is no doubt that a state may tax a corporation and also tax the holders of its stock. [Citation omitted.] The owners are different and, although the appellant calls it a mischievous fiction, the property is different." 282 U.S. at 23. Whatever the relationship between a corporation and the holder of its stock, it is well established that, with only limited exceptions, the two are separate taxable entities. *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949); *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943). Shares of stock are intangible property, that is, "rights which are not related to physical things." *Curry v. McCanless*, 307 U.S. 357, 365 (1939). They are the property giving rise to income to their owners. "The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members." *Klein v. Board of Tax Supervisors*, 282 U.S. at 24. The doctrine addressed in these cases has impact, not only in taxation, but in many other areas of the law. The legal conclusion urged by the taxpayer is not warranted by this Court's finding in *Mobil*, and would have implications far beyond the issues addressed in this case.

What the Court actually did in *Mobil* was in accord with its traditional role in state tax cases: it examined a state taxing scheme to determine whether any clear constitutional violations were apparent in the operation of the tax. *See Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940). Woolworth argues that *Mobil* establishes affirmative state taxation guidelines, although such action is not in keeping with this Court's prior decisions. *See Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). This Court has repeatedly refused to substitute its own judgment for that

of the state legislature;[29] instead, it has presumed the state scheme valid, unless shown by clear and convincing evidence that it violates some constitutional prohibition. This is all the Court did in *Mobil.*

C. Because New Mexico Has Not Included the Income of the Subsidiary Corporation in Woolworth's Apportionable Business Income, Due Process Requires No Adjustment to the Apportionment Formula.

Although the taxpayer has $8.75 million of tangible property located in New Mexico, meets a New Mexico payroll of almost $2 million and derives gross receipts from New Mexico of more than $13 million, it contends that formulary attribution of $402,000 of its income to its New Mexico operation constitutes a *per se* violation of due process. The actual tax New Mexico imposed on that income is miniscule. It amounts to only about $20,000, or .175 percent of the taxpayer's gross receipts earned in New Mexico.[30]

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[29] "In the first place, it is doubtful whether any legal test could adequately reflect the numerous and competing economic, geographic, demographic, social, and political considerations that must inform a decision about an acceptable rate or level of state taxation, and yet be reasonably capable of application in a wide variety of individual cases. But even apart from the difficulty of the judicial undertaking, the nature of the factfinding and judgment that would be required of the courts merely reinforces the conclusion that questions about the appropriate level of state taxes must be resolved through the political process. Under our federal system, the determination is to be made by state legislatures in the first instance and, if necessary, by Congress, when particular state taxes are thought to be contrary to federal interests." *Commonwealth Edison Co. v. Montana,* 101 S.Ct. 2946, 2959 (1981) (footnote omitted).

[30] For comparison purposes, it is interesting to examine the alternative method of computing income taxes provided by UDITPA, for a corporation having much less connection with New Mexico than Woolworth. Had

(Cont. p. 26)

1. No Violation of Due Process Has Been Shown.

The New Mexico statute apportions business income on the basis of three factors, similar to those used by Vermont in *Mobil.* If a taxpayer can show that in its case the apportionment factors do not fairly represent the extent of its activities in New Mexico, it may seek adjustment of the formula, so as to effectuate a reasonable attribution of income. Section 7-4-19 NMSA 1978. Woolworth, however, presented no evidence showing either that the amount of income attributed to New Mexico by the formula was unfair, or that another method would be equitable. At the hearing, as in *Mobil,* Woolworth's "principal object was to achieve the subtraction of the asserted nonapportionable income from the preapportionment tax base; the alternative request for modification of the apportionment formula went largely undeveloped." *Mobil,* 445 U.S. at 432. At the end of the hearing, the hearing examiner had no more idea of the specifics of Woolworth's desired formula adjustments than he did at the beginning of the hearing. Consequently, he concluded that Woolworth had not met the statutory burden of showing a "reasonable and specific proposal," and that therefore no factor adjustment was appropriate. (J.S.A. 37a) This conclusion was affirmed by the New Mexico Supreme Court. (J.S.A. 21a)

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30 (Cont. from p. 25)

Woolworth only sales activities attributable to New Mexico, and no property here, it would have been eligible to elect the alternative method of reporting provided in §7-5-2 NMSA 1978. That simple calculation allows such a taxpayer to pay a tax of only .75 percent of its gross sales in New Mexico: the resulting tax liability would be $97,500, almost 5 times the tax liability of which Woolworth now complains. *Cf. Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 280 (1978), wherein this Court noted that the taxpayer would have had no constitutional complaint if the state had imposed a more burdensome gross receipts tax, instead of the income tax of which Moorman complained.

Having thus waived its opportunity under New Mexico's statute to achieve an apportionment adjustment, Woolworth now argues that the adjustment is constitutionally required, because the New Mexico formula is "inherently arbitrary."[31] (Brief of Appellant at 32) Yet the taxpayer does not demonstrate any way in which New Mexico's apportionment formula attributes income to New Mexico " 'out of all appropriate proportion to the business' transacted" by the taxpayer in New Mexico. *Butler Bros. v. McColgan,* 315 U.S. 501, 507 (1942), quoting *Hans Rees' Sons v. North Carolina,* 283 U.S. 123, 135 (1931). Nor is there clear and cogent evidence showing that application of New Mexico's formula led to a "grossly distorted result." *Norfolk & Western R. Co. v. State Tax Commission,* 390 U.S. 317, 326 (1968).

The amounts attributable to New Mexico by the apportionment formula are reasonable in light of the activities of Woolworth in New Mexico. The factors of property, payroll and sales are appropriate ingredients of a formula, and reflect "the relative contribution of the activities in the various states to the production of the total unitary income," thereby allocating to the taxing state a "just proportion" of the profits of a unitary business. *Butler Bros. v. McColgan,* 315 U.S. at 509. It is impossible for a state to include every conceivable factor in an apportionment formula. *Gulf Oil Corp. v. Morrison,* 120 Vt. 324, 141 A.2d 671, 675 (1958). Where an apportionment formula is clearly designed to tax only the proportion of the taxpayer's income reasonably related to its New Mexico activities, the formula should not be overturned absent a factual showing that the amount of tax is unreasonable. *Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978); *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113 (1920).

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[31] Having failed to meet the statutory standard, the taxpayer should not now prevail in its due process contentions. *Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 275 (1978).

Woolworth contends that its evidentiary burden to show actual taxation of extraterritorial values is met by "the dramatic, nearly five-fold increase in appellant's New Mexico taxable income." (Brief of Appellant at 41) Woolworth's position is akin to the separate accounting analysis consistently rejected by this Court. *Cf. Exxon Corp. v. Wisconsin Department of Revenue,* 447 U.S. 207 (1980) (rejecting separate functional accounting); *Mobil* (rejecting separate geographical accounting). By identifying the "source" of certain income, Woolworth says it can show that amount not to be related to New Mexico. Woolworth then presumes the point that it wishes to prove: that the dividend income does not represent business income, and that only the amount remaining after subtraction of the dividend amount represents business income. This subtraction proves only that Woolworth's tax liability to New Mexico would be substantially less, if New Mexico did not include dividends in apportionable business income. *See Moorman,* 437 U.S. at 275 n. 9. As this Court pointed out in *Mobil,* "separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale." 445 U.S. at 438. Woolworth contends that New Mexico is limited to taxing only income attributable to Woolworth's activities in New Mexico. (Brief of Appellant at 33) However, the record shows almost nothing about the nature or extent of taxpayer's activities in New Mexico or the amount of income earned from those activities, other than that it operates a Woolworth store in Santa Fe (J.A. 20a), and that it has extensive property, payroll and sales located in New Mexico. (J.A. 57a) Woolworth's activities in New Mexico may very well produce the amount attributed here by formula, or even more; the total amount of income attributable to New Mexico by formula is only about three percent of its New Mexico gross receipts. *See Moorman,* 437 U.S. at 276. Besides, where the New Mexico business is an integral part of a much larger business, Woolworth's nationwide unitary business, it becomes irrelevant to

attempt to break out amounts attributable to only one activity of the unitary business. Every aspect of the business contributes to the production of income; the larger and more prosperous a business is, the more able it is to make advantageous use of the privileges and protections provided in a single state. *Ford Motor Co. v. Beauchamp,* 308 U.S. 331 (1939). Thus, the mere fact that the amount of income attributable to New Mexico is greater, because the unitary business receives substantial amounts of income from its intangibles investments, does not prove that the apportionment formula is inherently arbitrary.

Woolworth contends that New Mexico's apportionment statute violates due process because it attributes differing amounts of income to New Mexico, depending merely on the corporate structure of the taxpayer. (Brief of Appellant at 33) The facts do not support this contention. The unitary business taxed here does not operate through either divisions or subsidiaries. The single corporation and the unitary taxpayer in this case have identical boundaries. The taxpayer's foreign subsidiaries are not taxed as part of the unitary taxpayer.[32]

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[32] If the foreign subsidiaries were, instead, corporate divisions, there is no indication that New Mexico would automatically include them as part of the unitary taxpayer, as Woolworth assumes in its argument. Assuming that all other facts remained the same, the foreign divisions would not be included as part of the unitary taxpayer, because a mere change in the corporate structure of the taxpayer without more indicates nothing concerning the boundaries and number of unitary businesses being conducted. *Cf. Exxon.* Moreover, had Woolworth considered its foreign subsidiaries to be an integral part of its business operations, it could have included them in its business, for tax purposes, and thereby achieved the recognition in the apportionment factors of the activities of the foreign corporations that Woolworth argues is necessary. (Brief of Appellant at 36) New Mexico allows the use of combined reporting, when a unitary business is conducted by more than one corporation. (R. 49; New Mexico Income Tax Regulation 18(b)(2) at R. 130) In a combined report, the net business income is the combined income of each corporate member of the unitary group, except that intercorporate transactions are eliminated from the total income. The three factor formula includes the property, payroll and

(Cont. p. 30)

2. The Taxpayer Offers No Acceptable Alternative to New Mexico's Formula.

Woolworth has consistently disclaimed any contention that its foreign subsidiaries are part of its unitary business, and announces its agreement with the argument that worldwide combination cannot be required. (Brief of Appellant at 37) The formula adjustment Woolworth requests, however, is a hybrid utilizing a combination of factors in the apportionment formula, but no combination of the income of the separate corporations, in effect apportioning the income of the smaller business, the domestic unitary business, with reference to the location and reach of a much larger business, a worldwide unitary business.[33]

The taxpayer's contention that its proposed formula is constitutionally mandated lacks precedent.[34] While this Court

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32 (Cont. from p. 29)
sales of each member of the business. For a fuller explanation of the combination method, *see* Corrigan, *Mobil-izing Interstate Taxation,* XIII TAX NOTES, No. 15, October 12, 1981.

33 The taxpayer seems to change position, in its apportionment argument, and seems to indicate that the taxpayer is operating a unitary business with its subsidiaries. (Brief of Appellant at 33)

34 Commentators have proposed various methods of adjusting the apportionment formula when intangible income is to be apportioned. *E.g.,* Keesling, *The Impact of the Mobil Case on Apportionment of Income,* 1981 B.Y.U. L. REV. 87; Dexter, *Tax Apportionment of the Income of a Unitary Business: An Examination of Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 1981 B.Y.U. L. REV. 107; Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon and H.R. 5076,* 79 MICH. L. REV. 113, 128 (1980); Peters, *Supreme Court's Mobil Decision on Multistate Income Apportionment Raises New Questions,* 53 J.TAX 36, 39 (1980). The task of the states is to determine which, if any, of the proposals result in a fair determination of the value to a taxpayer of doing business in a taxing state. *Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978). This Court's function is to guard the outer limits and prevent a state from overreaching. *Wisconsin v. J.C. Penney Co.,* 311 U.S. 435 (1940).

has found that application of a particular formula violates due process in individual cases,[35] the Court has never departed from

> the basic principles that the States have wide latitude in the selection of apportionment formulas and that a formula-produced assessment will only be disturbed when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,' . . . or has 'led to a grossly distorted result.' [Citations omitted.]

Moorman, 437 U.S. at 274.

Here, as in *Moorman*, to adopt Woolworth's proposed formula adjustment would require "extensive judicial lawmaking," 437 U.S. at 278[36] and in this case would be based exclusively on hypothetical facts. Nothing could be further from the role defined by the Court for itself in state tax cases.

The proposed apportionment formula is unacceptable not only because Woolworth has failed to meet its heavy evidentiary burden, but also because it is based on unsupportable assumptions. The taxpayer assumes that including dividends in apportionable income is the same as including the income earned by a subsidiary corporation, which would justify factor adjustments. This assumption is incorrect because the rights to receive the two different types of income arise from different types of relations to property, *see* discussion *supra* at 23, and also because the amount of dividends distributed has no necessary relation to the amount of income earned by a corporation. A corporation is under no obligation to distribute all its income as dividends in any year, and may distribute income although it earns no income in a given year.

Also, Woolworth implicitly assumes that income in the form of dividends is intrinsically different from other income from

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[35] *E.g., Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931); *Norfolk & W.R. v. State Tax Comm'n*, 390 U.S. 317 (1968).

[36] *See also Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1940).

intangible properties. Although Woolworth concedes that it obtains ordinary business income in the form of interest, it makes no attempt to include in its apportionment formula the factors of the corporations (including its Canadian subsidiary) paying the interest. Although it concedes that it obtains ordinary business income from its investments in commercial paper and treasury notes (J.A. 27a), it makes no attempt to include the factors of the obligors under those notes. It offers no explanation why dividend income, arising from the recipient's legal rights as a purchaser of shares, should be treated differently.

It is interesting that Woolworth should rely on *People ex rel. Alpha Portland Cement Co. v. Knapp*, 230 N.Y. 48, 129 N.E. 202, 181 N.Y.S. 32 (1920), for its argument that factors of payor corporations must be included in an apportionment formula. That case does not support inclusion in the factors of the location of the payor, but rather inclusion of the location of the shares in the apportionment formula. Since intangible properties have no real location apart from the location of their owner, the philosophy underlying Judge Cardozo's opinion is consistent with New Mexico's contention that dividend income may be apportioned just as any other item of ordinary business income. The location of business intangibles is "wherever its tangible property is located and its work is done." *Adams Express Co. v. Ohio State Auditor*, 166 U.S. 185, 223 (1897); *Curry v. McCanless*, 307 U.S. 357 (1939).

Woolworth hopes for a second opportunity to present evidence of appropriate factors to be used in the apportionment formula, and reserves its right to object to any factors used in the apportionment formula. To paraphrase this Court, the Supreme Court of New Mexico "created no innovation and sprung no surprise when it placed on appellant the burden of establishing that the formula taxed extraterritorial values. As we have noted, that is settled doctrine." *Butler Bros. v. McColgan*, 315 U.S. at 510. It is fair to assume here, as in

Mobil, that the evidence, if presented, would not have supported Woolworth.

D. Foreign Exchange Gain Is Apportionable Business Income of Woolworth.

The taxpayer argues in a footnote that the foreign exchange gain it realized from a hedging transaction should be considered as identical to any dividends received from its English subsidiary, and that exclusion of those amounts from apportionable business income is therefore appropriate. (Brief of Appellant at 25 n. 12) Neither logic nor the evidence supports Woolworth in this argument.

Nothing in this record indicates that Woolworth's income from its hedging transaction is so inextricably related to its dividend income from its English subsidiary as to be inseparable for taxing purposes. Details of the transaction were not presented by Woolworth; the hypothetical situation described by the taxpayer's witness, Mr. Feeley, is inconsistent with the mechanism described by the taxpayer in its brief.[37] Apart from this inconsistency, little may be gleaned from the record concerning the nature of this item of income. Surely, the mere fact that

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[37] The hearing examiner heard testimony that would seem to indicate that the gain was received because of an increase in the ratio of dollars to pounds, by virtue of the testimony of Mr. Feeley: "We give them [the pounds] to them [the purchaser] at the stated price which we receive a dollar ninety-five for. At the same time the English company, then, disburses the pound to us and perhaps the market conditions are such that we can make fifty cents profit on the pound so that we will be getting two fifty. So, that is how a profit would arise." (J.A. 53a)

In appellant's brief, however, the reverse is asserted: "If the dividends were worth more in dollars when received than they were when declared, appellant's hedging transaction would result in a foreign exchange loss, and *vice versa*." (Brief of Appellant at 26 n. 12)

the pounds received in one transaction as dividend receipts are obligated, at least in part, to fill another contract for sale of pounds is insufficient support for the conclusion that proceeds from the two transactions are indistinguishable for state income tax purposes. The taxpayer has failed to meet its burden of showing that its income attributable to a foreign exchange gain is not part of the unitary business income includable in the apportionable business income pool.

Assuming that Woolworth entered into a true hedge, *see, e.g., Corn Products Refining Co. v. Commissioner,* 350 U.S. 46 (1955), and that its decision to do so may have been motivated by Woolworth's concern that fluctuating exchange rates would adversely affect the amount of dividends received from its English subsidiary, it does not follow that income from the hedging transaction arises from the same source as a dividend. The taxpayer itself arranges for the contract with a third party to sell a set number of pounds for a set number of dollars on a certain date.[38] The complicated calculations necessary to determine the desirability of a hedge[39] were most probably performed by financial managers employed by the party desiring to hedge – i.e., Woolworth. Someone on the payroll of Woolworth made the financial decision. Woolworth was the beneficiary of the contract and had the obligation to perform under the contract. In short, this hedging investment is no different from Woolworth's commercial paper investments, which it has conceded to be part of its business. In the absence of a showing by the taxpayer that the income is from a discrete business

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[38] Polk, *Financial and Tax Aspects of Planning for Foreign Currency Exchange Rate Fluctuations,* 56 TAXES 131, 135 (1978).

[39] *See* Costello, *Tax Consequences of Speculation and Hedging in Foreign Currency Futures,* 28 TAX LAW. 221, 240-242 (1975).

activity, it is a part of the unitary business carried on in New Mexico.[40]

II. THE INCLUSION OF SECTION 78 INCOME IN APPORTIONABLE BUSINESS INCOME DOES NOT VIOLATE DUE PROCESS.

New Mexico, as do many other states, measures its income tax by the amount reported by a taxpayer on its federal return as federal taxable income. Section 7-2-2(S) NMSA 1978. Woolworth indicated on its federal return that its taxable income was $88 million. Nonetheless, it seeks to exclude from its New Mexico taxable income base $25.5 million of its federal taxable income included pursuant to section 78 of the Internal Revenue Code. New Mexico submits that Woolworth's federal taxable income is a fair approximation of this taxpayer's unitary business income.

To succeed the taxpayer must prove that the state's reliance on federal taxable income results in taxation of an amount which bears no rational relationship to "values connected with the taxing state," *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978), or which has no "nexus" with the state. *Mobil*, 445 U.S. at 437. A state may devise any reasonable scheme for determining taxable income; New Mexico has chosen to rely on federal taxable income as a reasonable approximation of a

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[40] Even if taxpayer's assertion – that the transactions were not "independent, speculative investment" (Brief of Appellant 26 n. 12) – had been established by the facts, the implications do not support Woolworth. In the federal tax scheme, the problem addressed by characterization of a transaction as a "hedge," rather than as an "independent, speculative investment," is the question of whether the gain or loss is capital or ordinary. If the transaction is a true "hedge," the income or expense is ordinary, because "a hedge has always been viewed as a means of protecting ordinary operating profits realized in the day-to-day operation of the business enterprise." *Hoover Co. v. Commissioner*, 72 T.C. 206, 238 (1979).

taxpayer's apportionable business income.[41] The constitutional test is not whether New Mexico's tax is imposed on "income," as used in the sixteenth amendment.[42] Discussion of whether an item is truly "income" is irrelevant to consideration of the due process limitations imposed on a state's power to tax, and Woolworth has not shown that due process is violated by inclusion of the gross-up dividend amount. *See* Section I, *supra.*

In any event, Woolworth's characterization of gross-up income as nothing more than "one part of a computational formula" (Brief of Appellant at 28) does not withstand analysis. The requirement that a taxpayer "gross-up" income is a logical part of the federal scheme for taxing entities which do business abroad. Sections 901 and 902 of the Internal Revenue Code address two basic situations in which a domestic corporation receives income from its operations abroad. Where the domestic corporation operates abroad through a foreign division, the taxpayer declares the total of the division's income, but is allowed a credit against the United States' tax for taxes it paid

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[41] Federal taxable income is itself an approximation. Examination of each item included in and subtracted from gross income in order to arrive at federal taxable income reveals more about federal tax policy than it does about a taxpayer's "real" economic income. Deductions and credits may reflect current federal economic policies; for example, the recently adopted Accellerated Cost Recovery System, Pub. L. No. 97-34, §201(a), 95 Stat. 204 (1981) (to be codified in I.R.C. §168), which applies accellerated methods of cost recovery over statutory periods, will result in a decrease in federal taxable income, although a taxpayer's real economic income may remain the same.

[42] The sixteenth amendment does not affect the state's right to tax. Since the sixteenth amendment expressly authorized Congress to impose taxes only on income, this Court has been required to address the question of the nature of income, in a constitutional sense, in determining whether a tax is constitutionally permitted to the federal government. This is all the Court determined in *Eisner v. Macomber,* 252 U.S. 189 (1920), and *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426 (1955). These constitutional limitations do not apply to the states.

to a foreign government. I.R.C. §901. Where the corporation operates abroad through a foreign subsidiary, the parent corporation may elect to claim a credit for a proportionate amount of the taxes paid by the foreign subsidiary to a foreign country. I.R.C. §902. Through section 902(a), Congress has extended "the same tax treatment to a domestic corporation with a foreign subsidiary as is accorded a domestic corporation with a foreign branch within the same corporate shell." *Associated Telephone & Telegraph Co. v. United States,* 306 F.2d 824, 832 (2d Cir. 1962). If the domestic parent corporation chooses to take the foreign tax credit under section 902, it must increase or "gross-up" its taxable income by an amount equal to the foreign taxes paid by the foreign subsidiary. I.R.C. §78.

Prior to the enactment of section 78 in 1962,[43] section 902 in effect gave both a deduction and a credit for the foreign tax, in that the dividends on which the domestic corporation paid the tax did not include the amount of the income of the foreign corporation used to pay the foreign tax. H.R. REP. No. 1447, 87th Cong., 2d Sess. 50 (1962); S. REP. No. 1881, 87th Cong., 2d Sess. 66 (1962). *See* 5 MERTENS, LAW OF FEDERAL INCOME TAXATION §33.14 (Repl. Vol. 1980); Bodner & Shapiro, *The Fundamentals of the Foreign Tax Credit,* 47 TAXES 424, 426 (1969).[44] The practical effect of this was that

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[43] The gross-up provision was added by Pub. L. No. 87-834 §9(b), 76 Stat. 1001 (1962).

[44] A domestic corporation operating abroad through a branch was subject to United States tax on the entire amount of its earnings abroad, with the foreign tax credit applicable to the United States tax. In contrast, a taxpayer operating abroad through a subsidiary would receive an amount as a dividend from which the foreign taxes had already been subtracted (the "deduction" for foreign taxes) and was then also allowed the foreign tax credit. The House and Senate both prepared charts which were illustrative of the tax differential which resulted from the omission of this amount, stating that "[t]he tax differential represents the difference between the U.S. and foreign tax rates, multiplied by the income omitted from the U.S. tax base." H.R. REP. No. 1447, 87th Cong., 2d Sess. 51 n. 3 (1962); S. REP. No. 1881, 87th Cong., 2d Sess. 67 n. 3 (1962).

"the full U.S. tax [was] not paid on most dividend income received by domestic corporations from foreign corporations." S. Rep. No. 1881, at 68.

Section 78 rectified this situation by requiring that a taxpayer electing the foreign tax credit "increase, or 'gross-up,' his U.S. tax base by including in it the amount of foreign income paid in taxes which is attributable to the dividend received." H.R. REP. No. 1447, at 52.[45] The legislative history of section 78 demonstrates that Congress intended to require domestic taxpayers to increase the amount of income they recognized from their operations abroad. The enactment of section 78 does not simply generate a number against which a credit can be taken. As the House and Senate Committees noted, the recognition of section 78 dividend income results in the treatment of that amount as income for purposes of other sections of the Code:

> The amount included in gross income by operation of section 78 is treated as a dividend in the same manner as a dividend actually received by the domestic corporation from a foreign corporation. For example, a section 78 dividend is included in gross income under section 61(a)(7); is personal holding company income for purposes of section 543(a)(1); and may be a portion of accumulated taxable income for purposes of section 535. However, a section 78 dividend is not a dividend for purposes of section 245 of the code (relating to deduction for dividends received from certain foreign corporations).

H.R. REP. No. 1447, Technical Explanation, at A83; S. REP. No. 1881, at 227.

Section 78 requires a domestic corporation to gross-up its dividend income as a condition of the election to take the

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[45] The foreign credit is not based on the taxes paid on the entire income of the foreign subsidiary, but is rather derived from the ratio of the taxpayer's dividend income to the subsidiary's accumulated profits. I.R.C. §§902(a) and 902(c).

foreign tax credit under section 902. In contrast to other circumstances in which income must be recognized under the "tax benefit rule," such as where a bad debt previously deducted by the taxpayer is recovered, *see* I.R.C. §111, section 902 permits domestic corporation to receive a direct economic benefit for taxes it did not directly pay. The gross-up amount under section 78 is no less income for tax purposes than income attributed under the tax benefit rule. The state may rely on the federal characterization of both as gross income for tax purposes without being required to allow offsetting deductions or credits.

The imputation of income under section 78 results from the taxpayer's voluntary election to seek the benefit of the foreign tax credit. As the Appellate Court of Illinois stated, in considering Caterpillar's attempts to deduct gross-up dividend income, subpart F income, and foreign taxes from its federal taxable income:

> In making these elections, the taxpayer has, presumably, lessened its federal income tax liability. Now, the plaintiffs in this case also want to reduce their Illinois income tax liability by reversing the effect of their elections. . . .
>
> . . . As a result of their own elections, the plaintiffs have not deducted the amount of foreign taxes from and have added certain hypothetical income to their gross income, and for federal income tax purposes, they are bound by those elections. Nothing in our existing Illinois law can be found to relieve the plaintiffs of the consequences of their choices for Illinois income tax purposes.

Caterpillar Tractor Co. v. Lenckos, 77 Ill.App.3d 90, 395 N.E. 2d 1167, 1176-1177 (App.Ct. 1979), prob. juris. noted *sub nom. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, ___U.S.___, No. 81-349 (the deductibility of these items was not appealed to this Court). *See, e.g., Taxation and Revenue Department v. F. W. Woolworth*, 95 N.M. 519, 624 P.2d 28 (1981), prob. juris. noted, No. 80-1745 (J.S.A. 1a); *Commonwealth v. Westinghouse Electric Corp.*, 478 Pa. 164, 386 A.2d 491 (1978), *appeal*

dismissed, 439 U.S. 805 (1978); *Albany International v. Halperin,* 388 A.2d 902 (Me. 1978); *Commonwealth v. Rohn & Haas Co.,* 28 Pa. Commw. Ct. 430, 368 A.2d 909 (1977).

Many states rely ("piggyback") on federal taxable income in their taxing schemes. The simplicity of this system benefits both the state and the taxpayer, as Woolworth concedes. (Brief of Appellant at 29) Absent such reliance, a multistate corporation could be faced with fifty taxing schemes as complicated as the federal one; the states would be saddled with auditing and enforcement problems far beyond their individual capacities.

The federal characterization of an amount as dividends has been followed in various state cases, sometimes with advantageous consequences for taxpayers, and sometimes for state tax departments. *See, e.g., Dow Chemical Co. v. Commissioner of Revenue,* 378 Mass. 254, 391 N.E.2d 253 (1979); *Commonwealth v. Emhart Corp.,* 443 Pa. 397, 278 A.2d 916 (1970), *cert. denied,* 404 U.S. 981 (1971). The inclusion of gross-up in federal taxable income has been specifically permitted because of the economic benefit provided by the election to claim the federal tax credit. *Taxation and Revenue Department v. F.W. Woolworth; Caterpillar Tractor Co. v. Lenckos.*

The assertion that "fictional income" is being taxed as a result of state reliance on federal taxable income is not uncommon. Numerous provisions of the Code can result in the inclusion of income that taxpayers characterize as fictional, such as the requirement that a shareholder of a subchapter S corporation recognize undistributed taxable income. *See Garlin v. Murphy,* 51 Misc.2d 477, 273 N.Y.S.2d 374 (1966), *aff'd,* 34 N.Y.2d 921, 359 N.Y.S.2d 552 (1974). Although Woolworth views this and two other state cases (*Dow Chemical Co. v. Commissioner of Revenue* and *Champion International Corp. v. Bureau of Revenue,* 88 N.M. 411, 540 P.2d 1300 (Ct.App. 1975)) as merely presenting instances in which federal provisions have changed the time when income is recognized (Brief

of Appellant at 29 n. 15), this description minimizes the very real consequences of altering the time at which income is recognized. For example, a state might lose jurisdiction to impose a tax, so that the deferral of income would be permanent.

Because the federal tax code is so complex, its application results in the formulation of taxable income primarily to achieve a desired economic result. A state's reliance on federal taxable income may result in the taxation of income not yet received, but it may also result in the failure to tax income realized but not recognized.[46] The due process clause should be used to scrutinize the ultimate result of the state's reliance on federal taxable income, not the state's every inconsistency with the federal scheme.

III. THE FOREIGN COMMERCE CLAUSE DOES NOT BAR NEW MEXICO'S INCLUSION IN APPORTIONABLE BUSINESS INCOME OF DIVIDENDS RECEIVED BY BY WOOLWORTH FROM ITS FOREIGN SUBSIDIARIES.

Woolworth argues that the inclusion of its dividend, foreign exchange and gross-up income in apportionable business income will necessarily violate the foreign commerce clause unless New Mexico adjusts Woolworth's apportionment factors.

Woolworth's entire argument is premised on a purported difference between this case and *Mobil*, namely, that the taxpayer in *Mobil* conceded that its dividends were "fully taxable in the State of commercial domicile" (Brief of Appellant at 42), whereas Woolworth has not made that concession. In fact, at

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[46] *See, e.g.*, the deferral of income under section 1031 of the Internal Revenue Code (tax free exchange of like kind property).

every stage of the proceedings prior to its appearance in this Court, Woolworth has maintained that its dividend income should be allocated to its state of commercial domicile.[47] The argument that Woolworth's dividends should not be allocated to the state of commercial domicile has not been presented to any New Mexico court or administrative body. The Supreme Court's review is limited to the specific federal question that was raised in the courts below. *See Wilson v. Cook*, 327 U.S. 474, 483 (1946). Woolworth cannot now maintain that its change in position is insignificant and the Court should decline to review this point.

The foreign commerce clause question was first raised by Woolworth in its brief in the New Mexico Supreme Court. Consequently, the record does not indicate what taxes were paid on Woolworth's dividends abroad. Woolworth's theories regarding the application of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), have far ranging implications for the entire structure of state taxation and require full development prior to their consideration by this Court.

Woolworth's interpretation of the Court's decision in *Japan Line* is unjustified in view of the Court's subsequent analysis of that case in *Mobil*. Woolworth distinguishes *Mobil* because the taxpayer in *Mobil* conceded that its dividend income was "fully taxable in the State of commercial domicile" (Brief of Appellant at 42), whereas Woolworth asserts that *Japan Line* bars taxation in the absence of such a concession. In effect, Woolworth makes the novel argument that dividend income from foreign investments of a domestic corporation might not be taxable in any

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[47] In Woolworth's Memorandum Brief in the New Mexico Court of Appeals, it argued that "dividend income . . . should be separately allocated to Woolworth's state of commercial domicile." (R. 146) It maintained the same position in the New Mexico Supreme Court and in its Jurisdictional Statement in this Court. (J.S. at 7)

state.[48] The full implications of that position are significant. For Woolworth to escape the holding in *Mobil* it must show that it has "nowhere" income;[49] that is, income of an American business which is neither apportionable nor allocable to any state. If Woolworth is incorrect in this assertion, then the Court's decision in *Mobil* is directly applicable. That decision conclusively rejected the same contentions made by Mobil and disposes of Woolworth's foreign commerce clause arguments.

Woolworth's invocation of *Japan Line* and the foreign commerce clause cannot advance it beyond the argument it urges in the earlier sections of its brief. For *Japan Line* to even apply the taxpayer must show that "foreign commerce" is affected by New Mexico's taxing scheme. If New Mexico has simply taxed income attributable to Woolworth's activities within the United States, then no taxation of foreign commerce has occurred. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,*

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[48] Woolworth's claim that *no state* has the right to tax its income from dividends is a radical departure from traditional legal doctrine. In commenting on legislation which would restrict the taxation of dividend income, Professor Hellerstein stated:

> There is no legal foundation for the contention that a jurisdiction's right to tax dividends received by a payee depends on the connection of the jurisdiction to the production of the income underlying the dividend. Dividend income and operating income have traditionally been treated as distinct items of taxable income, and the power to tax the latter has never been a constitutional predicate of the power to tax the former . . . . Dividend income has traditionally been attributed to states for income tax purposes based on commercial domicile, business situs and other theories, without regard to operating income. Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon and H.R. 5076,* 79 MICH.L.REV. 113, 169 (1980) (footnote omitted).

[49] This term is used to describe income that escapes taxation by any state. Corrigan, *Interstate Corporate Income Taxation – Recent Revolutions and a Modern Response,* 29 VAND.L.REV. 423 (1976).

266 U.S. 271 (1924). *See United States Steel Corp. v. Multistate Tax Commission*, 434 U.S. 452, 477 (1978).

Thus, the foreign commerce clause does not come into play unless New Mexico has overreached and taxed income which is attributable to foreign activities; whether New Mexico has done so is the subject of the debate over the apportionment formula. Indeed, Woolworth concedes that under the theory of apportionment, "the taxing State is not taxing any out-of-state income as such, but is simply using the out-of-state income, and the out-of-state property, payroll and sales factors, as a means of more accurately calculating the portion of the total income which is fairly attributable to activities in the taxing State." (Brief of Appellant at 45) Accordingly, the appellant argues, adjustment of the apportionment formula would avoid the foreign commerce question. (Appellant's "Questions Presented" No. 3; Brief of Appellant at 45)[50] However, the burden is on Woolworth to prove that New Mexico's statute taxes foreign income, rather than income from Woolworth's activities in the United States. Woolworth has not met that burden.[51] Therefore, the conclusion that New Mexico's taxing scheme fairly attributes to New Mexico that income which results from the taxpayer's activities in New Mexico is dispositive of the foreign commerce clause issue.[52]

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[50] While the appellant firmly maintains that "the foreign commerce clause will be violated unless a correlative adjustment is made to New Mexico's apportionment factors" (heading of Section III, Brief of Appellant at 32), it is less clear what that requested adjustment is. The appellant's argument on this point is ambivalent. It argues at an earlier point in its brief that its subsidiaries' apportionment factors must be included in the determination of its apportionable business income. (Brief of Appellant at 36, 40) Here it states that unitary apportionment of foreign source income might not be "constitutionally acceptable in practice, even if theoretically appropriate apportionment factors are used." (Brief of Appellant at 45 n. 26)

[51] *See* discussion *supra* at Section I(B) and I(C) of this brief.

[52] As the Court noted in *Mobil*, the implications of the "foreign com-

(Cont. p. 45)

Since the dividend income in question is attributable to Woolworth's activities in the United States, no restraint on state taxation arises from Woolworth's allegations of double taxation. The United States has the right to tax this income, although it has chosen to relieve domestic taxpayers of some of the burdens of double taxation. I.R.C. §901. Of course, the states are not barred from taxation because the federal government is also entitled to tax the same amount. *See Mobil*, at 448.[53]

Woolworth also argues that *Japan Line* stands for the principle that the federal policy which Woolworth discerns with regard to the taxation of dividend income is sufficient to bar state taxation of dividend income from foreign investments. *Japan Line* established a different rule for examination of state taxation of foreign commerce than that generally applicable to state taxation schemes.[54] Allegations of a general conflict between state law and national policy are usually not sufficient

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52 (Cont. from p. 44)
merce" argument cannot be limited to dividend income. 445 U.S. at 447. Any income could be alleged to have a foreign "source"; whether it is true in a particular case must be determined by the unitary business principles in Section I of this brief.

53 Professor Hellerstein rejected the double taxation argument which is made by proponents of legislation to prohibit state taxation of foreign source dividends when the foreign taxes give rise to a federal foreign tax credit: "But the federal foreign tax credit is designed to avoid duplicative taxation at the national level of earnings derived from sources outside the United States. It has – or should have – no bearing on the power of a state to tax such income. State income taxes have always been imposed in addition to federal income taxes." Hellerstein, *supra* note 48, at 1169 (footnotes omitted).

54 The primary question presented in *Japan Line* was whether California's taxing authority over property in its state was restricted by the need for a uniform federal policy in governing relations between the two nations. The Court held that the regulation of foreign commerce was "preeminently a matter of national concern," 441 U.S. at 448, so that state taxation which frustrated the "achievement of federal uniformity," 441 U.S. at 450, would be pre-empted.

to pre-empt state law: " '[p]re-emption of state law by federal statute or regulation is not favored "in the absence of persuasive reasons – either that the nature of the regulated subject matter permits no other conclusion, or that the Congress has unmistakably so ordained.' " [Citations omitted.]" *Commonwealth Edison Co. v. Montana*, 101 S.Ct. 2946, 2962 (1981). Where the argument is made that a general national policy is frustrated by a state's taxing policies, the Court finds it necessary to "look beyond general expressions of 'national policy' to specific federal statutes with which the state law is claimed in conflict." *Id.*, (footnote omitted). In contrast to *Japan Line*, this case does not involve a state's attempt to regulate foreign commerce. Therefore, any argument that federal policy pre-empts the state taxing policy requires an unmistakable indication of congressional intent to do so.

There is no specific federal statute which bars state taxation of the income of corporations with foreign investments, nor is there any other indication of a congressional policy to do so. The applicable treaties with Canada and West Germany are silent on the subject of state taxation; there is no income tax treaty with Mexico. The mere enactment of revenue laws and treaties (*see* Brief of Appellant at 46-48) providing that the United States will accord a certain treatment to dividends from foreign investments for federal income tax purposes is not sufficient to dictate that the states accord identical treatment. As the Court stated in *Mobil:* "Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." 445 U.S. at 448.[55]

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[55] Woolworth maintains that this statement was made about "multiple taxation among our states." (Brief of Appellant at 49 n. 31) The quoted statement refers not to overlapping state taxation, but rather to whether states must tax all income in the same manner the federal government does, and has no relevance to taxation among the states.

Furthermore, Woolworth has cited no affirmative statement that Congress intended to restrict the treatment which the various states give to dividends paid by foreign corporations. Congress specifically withheld its consent from even less restrictive provisions of the United States–United Kingdom tax treaty which would have prohibited the states from applying the unitary apportionment method to subsidiaries and enterprises in the United Kingdom.[56] Following the Senate's rejection of these limitations on state taxing power, two bills were introduced to restrict the state's power to tax dividends from foreign corporations and from domestic corporations with substantial foreign source income.[57] Neither bill was enacted.

Finally, the federal policy regarding the taxation of dividends from investments in foreign operations is not comparable to the policy addressed in *Japan Line* regarding the taxation of containers used as instrumentalities of foreign commerce. In *Japan Line* the federal policy essentially prohibited any taxation by the nondomiciliary country.[58] Federal law here *permits* the taxation of foreign source dividends.[59] Yet, Woolworth points to the federal policy underlying the allowance of a foreign tax

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[56] 124 CONG.REC. S. 9840, 95th Cong., 2d Sess. (1978).

[57] H.R. 5076, 96th Cong., 1st Sess. (1979); S. 1688, 96th Cong., 1st Sess. (1979). Virtually identical bills were introduced in the first session of the 97th Congress: H.R. 1983, 97th Cong., 1st Sess., 127 CONG. REC. E. 619 (daily ed. Feb. 23, 1981); and S. 655, 97th Cong., 1st Sess. (1981).

[58] In *Japan Line* a customs convention barred the imposition of duties and taxes on containers temporarily imported into the United States. 441 U.S. at 453. The language of the convention has been described as sufficient in itself to bar property taxation. 19 VA. J. INT'L L. 915, 928 n. 65 (1979).

[59] A credit is provided for certain types of foreign taxes, but the United States may receive far more in taxes than does the foreign nation. For example, the appellant states that the English dividends were subject to a 5% withholding tax in the United Kingdom while the effective rate in the United States at that time was 48%.

credit, which merely reduces the effective United States tax rate, to derive a policy that would *entirely* prohibit state taxation.

Apart from these threshold barriers to the use of *Japan Line*, the case is not easily applied to the situation presented by the taxation of a domestic corporation's dividend income. In *Japan Line* California attempted to tax vessels that were owned, based and registered abroad. 441 U.S. at 436. The Court specifically objected to the "home port doctrine" because it would have the effect of barring taxation by a nondomicilary state of a domestically owned vessel, 441 U.S. at 443, and stated that it did not reach the question raised by domestically owned instrumentalities engaged in foreign commerce. 441 U.S. at 444 n. 7.[60] It cannot be assumed that the same concern for the nation's relations with foreign countries is implicated by its taxation of its own domiciliaries.

Additionally, the taxpayer in *Japan Line* demonstrated actual multiple taxation between Japan and California. 441 U.S. at 452 n. 17; *Mobil*, 445 U.S. at 448. The taxpayer cites in this Court for the first time laws of foreign countries which purportedly subjected the taxpayer's dividend income to taxation (Brief of Appellant at 43-44), and it implies that these taxes were actually paid. (Brief of Appellant at 43-44) Woolworth introduced no evidence in the record as to what specific foreign taxes it actually paid with respect to its dividend income.[61]

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[60] *See* Keesling, *The Impact of the Mobil Case on Apportionment of Income*, 1981 B.Y.U.L. REV. 87, 96 (1981) ("In any event, *Japan Line* would have no application to domestic corporations deriving income from foreign sources").

[61] The federal corporate tax return requires information concerning the payment of foreign taxes: Woolworth did not introduce this schedule (form 1118) at the hearing below and it is not part of the record. The statutory provisions cited by the taxpayer are not self-explanatory; for example, one cannot tell what the rate of the tax was nor the amount of tax actually paid in West Germany.

Ultimately, Woolworth's attempt to bring this case within the holding in *Japan Line* requires a generous attitude towards the carefully drawn language of the *Japan Line* decision. *Japan Line* addressed a very different situation from that present here: vessels used exclusively in foreign commerce, registered, based and owned in foreign countries, subject to property tax in a foreign country, and in fact taxed there, *Japan Line*, 441 U.S. at 436; a tax imposed on ownership, not income, *Mobil*, 445 U.S. at 446; the extension of tax immunity by the foreign country to vessels domiciled in the United States, *Japan Line*, 441 U.S. at 437; and, an apparent tradition of tax immunity. These distinctions suggest that compelling reasons based in constitutional analysis are required to support the application of *Japan Line* to this case. The reasons Woolworth has offered in support of its foreign commerce clause argument are legislative in nature and should be directed to a legislative forum.[62]

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[62] Woolworth does not discuss the tax treatment of exchange gain or gross-up dividend income by foreign governments, nor the policy of the United States towards foreign taxation of these amounts. Additionally, there is no evidence, for example, of where the foreign exchange transactions occurred. To the extent that Woolworth's argument does apply to these items, New Mexico's response is contained in this section.

CONCLUSION

For all the foregoing reasons, New Mexico requests this Court to affirm the decision of the New Mexico Supreme Court.

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